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A DOLLAR CRASH?

Euro Trashing

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"The convention whereby the dollar is given a transcendent value as an international currency no longer rests on its initial base. ... The fact that many states accept dollars ... in order to make up for the deficits of [the] American balance of payments has enabled the United States to be indebted to foreign countries free of charge. Indeed, what they owe those countries, they pay ... in dollars that they themselves can issue as they wish. ... This unilateral facility attributed to America has helped spread the idea that the dollar is an impartial, international [means] of exchange, whereas it is a means of credit appropriated to one state."

Thus spoke Charles de Gaulle in 1965, during a press conference often cited by historians as the beginning of the end of postwar international monetary stability. De Gaulle's argument was that the United States was deriving unfair economic advantages from possessing the principal international reserve currency. To be precise, it was financing its own balance-of-payments deficit by selling foreigners dollars that were likely to depreciate in value.

The striking thing about de Gaulle's analysis is how aptly it describes the role of the dollar in 2004. That is itself ironic, since the general's intention was, if possible, to topple the dollar from its position as the world's number-one currency. In this, he utterly failed. True, pressure on the dollar grew steadily in the wake of de Gaulle's remarks. By 1973, if not before, the system of more-or-less fixed exchange rates that had been devised at Bretton Woods in 1944 was dead; the world entered an era of floating exchange rates, not to mention high inflation. Yet, even in the darkest days of the '70s, the dollar did not come close to losing its status as a reserve currency--that is, the currency in which international finance and commerce is transacted. Indeed, so successfully has the dollar continued to perform this role that, in the course of the past decade, some economists have begun speaking of Bretton Woods II--a new system of more-or-less fixed exchange rates with the dollar, once again, as the key currency.

As de Gaulle understood, this state of affairs promises the United States real benefits. As long as the dollar is ascendant, the United States can continue to run huge trade and budget deficits without having to worry about serious economic fallout. But, if the dollar were to lose its status as the world's reserve currency, the economic consequences would be grave. Unfortunately for Americans, the sheer magnitude of the imbalances in America's financial position, along with the emergence of a suitable alternative to the dollar--the euro--now make this a real possibility.

The existence of a dollar standard may come as something of a surprise to any American who has been considering a summer holiday in Europe. With the euro having appreciated to \$1.20 (compared with around 85 cents two years ago), talk of a new era of fixed exchange rates centered around the dollar seems as far-fetched as the current asking price of a Tuscan villa. But "Son of Bretton Woods" is not a global system. It is primarily an Asian system. At the system's core, with their currencies firmly pegged to the dollar, are China, Hong Kong, and Malaysia. Also linked to the dollar, though less rigidly, are the currencies of India, Indonesia, Japan, Singapore, South Korea, Taiwan, and Thailand.

Even more than it was in the '60s, this system is highly beneficial to the United States. Over the past decade or so, the U.S. current account deficit--the difference between all that the United States pays to the rest of the world for goods, services, and loans, and all that it earns from the rest of the world--has widened dramatically, to around 5 percent of gross domestic product (GDP). Add together the portion of federal debt held by foreigners and you arrive at a total external debt of almost \$3 trillion. At the end of 2002, according to the Department of Commerce, the net international indebtedness of the United States was equivalent to around a quarter of GDP. This is all the more remarkable given that, as recently as 1988, the United States was still a net creditor.

This rapid role reversal--from the world's banker to the world's biggest debtor--has created two advantages for Americans. First, it has allowed U.S. businesses to invest substantially (notably in new information technology) without requiring Americans to reduce their consumption. Somewhere between 10 and 20 percent of all investment in the U.S. economy in the past decade has been financed out of the savings of foreigners, allowing Americans to spend, spend, spend--the personal savings rate is less than half what it was in the '80s--while, at the same time, reaping the benefits of increased productivity through improved technology.

The second payoff has taken the form of lavish tax cuts--or, more precisely, freedom from the consequences of the large deficits they create. The dramatic shift in the finances of the federal government from a surplus of \$236 billion in 2000 to a deficit of more than \$520 billion in 2004--a nearly unprecedented deterioration, according to the International Monetary Fund--has also been substantially funded from abroad. The reason is simply that foreigners are willing to buy the new bonds issued by the U.S. Treasury at remarkably high prices (which imply low rates of return, i.e., interest rates). In the past ten years, the share of the privately held federal debt in foreign hands has risen from 20 to 45 percent.

Had that not been the case, the combination of tax cuts, increased spending, and cyclically reduced revenue that has characterized President Bush's fiscal policy would have led to much more severe increases in long-term U.S. interest rates. Indeed, according to Paul Krugman, a sudden loss of appetite for dollars abroad could quickly send the ten-year bond rate to 7 percent and the 30-year mortgage rate to 8.5 percent. (When the demand for U.S. dollars dries up, Americans must offer higher interest rates to persuade foreigners to hold them.)

These developments would have devastating economic consequences. A 3 percent jump in long-term rates would whack both the federal government and American homeowners with considerable force. For, unlike big U.S. corporations, which increasingly use derivative contracts to reduce their exposure to interest-rate risk, neither the U.S. Treasury nor the average American household is even the slightest bit hedged. In the case of the government, higher rates would mean higher debt-service costs as Treasury bills mature and new debt is issued. In the absence of tax

hikes, higher debt-service costs would mean bigger deficits, too. The U.S. government could pretty soon find itself in a vicious circle, in which higher interest rates lead to larger deficits and larger deficits lead to higher interest rates. Meanwhile, even as interest rates have begun nudging upward, the proportion of new U.S. mortgages that have adjustable rates, rather than fixed ones, has risen from around 12 percent in late 2002 to 32 percent. That means a substantial chunk of American homeowners would immediately feel the pain if rates rose more steeply.

To understand the macroeconomic consequences of such pain, bear in mind that, since the mid-'90s, the consumer has been the driving force behind U.S. economic growth: As a percentage of GDP, personal consumption rose from 67 percent in 1998 to 71 percent in 2003. Low interest rates have been central to this story, allowing Americans to keep consuming by taking on debt even while their incomes have been flat. Since 1990, American households have increased their indebtedness significantly, from around 84 percent of income to around 115 percent. A 3 percent increase in interest rates would discourage consumption by making it very expensive to take on additional debt. Worse, it could push up the percentage of disposable income devoted to servicing existing debt from 18 percent today to well over 20 percent. That would leave families with much less money to spend, which would further crimp consumption and slow the economy.

This grim scenario is dismissed as exceedingly remote by proponents of the new Bretton Woods system, who see no reason why the arrangement shouldn't have a rosy, boundless future. The Asians, the argument goes, will keep on buying dollars and U.S. Treasuries--first, because they desperately need to avoid a dollar slide and, second, because there is no theoretical limit on how much of their own currency they can print in order to make their dollar purchases.

There is some truth to both these points. The East Asian monetary authorities have, to date, been willing to buy mind-boggling quantities of dollars in order to sustain the system. Between January 2002 and December of last year, the Bank of Japan's foreign exchange reserves grew by \$266 billion. Those of China, Hong Kong, and Malaysia rose by a combined \$224 billion. Taiwan acquired more than \$80 billion. Nearly all of these increases took the form of purchases of U.S. dollars and dollar-denominated bonds. In the first three months of this year alone, the Japanese bought another \$142 billion.

The Asian central banks' motivation for doing so has nothing to do with the dollar's being a good investment. (It's not. The return on a ten-year U.S. Treasury a year ago was around 4 percent, but the dollar has declined relative to the Japanese currency by 9 percent in the same period.) Their motivation was to prevent their own currencies from appreciating relative to the dollar--because a weak dollar would hurt their exports to the mighty U.S. market. (When the dollar is weak, imported goods cost American consumers more money.) Were it not for these interventions, the dollar would certainly have depreciated relative to the Asian currencies, though probably not by quite as much as it has against the euro.

But, eventually, there must be a limit to the Asians' appetite for dollars. The East Asians can hardly be oblivious to the fact that American public and private indebtedness is on an unsustainable growth path. And they know full well that their economic future hinges on the growth of their own domestic demand, rather than continued reliance on exports to the United States. In a lecture in Washington in March, Harvard President Larry Summers--who combines a world-class economic mind with the experience of economic policy-making at the very top--argued that "the growth plans of others that rely on export-led growth will need to be adjusted in

the years ahead," given that the over-leveraged American consumer could give out at any moment.

Moreover, the Chinese in particular know that there are real risks in a policy that involves so much money-creation for the sole purpose of buying dollars and dollar-denominated bonds. Expanding the money supply in this way is potentially inflationary; indeed, the monetary overheating that worried policymakers in Beijing earlier this year was at least partly due to the country's exchange-rate policy. If the Chinese want to avoid creating a bubble for themselves at home, they may have no choice but to let the yuan appreciate against the dollar.

The second problem with the current optimism is that international capital flows are much larger today than they were even ten years ago--meaning that a loss of confidence in the dollar would have much wider ramifications than it did in the late '60s, when attention focused on the gold convertibility of the dollar. Should Asian central banks even temporarily lose their appetite for dollars, interest rates could spike immediately, creating a self-reinforcing cycle of a falling dollar exchange rate and rising U.S. interest rates. The United States, then, would face a crisis not unlike the ones that afflicted the Mexican peso in 1994 or the Thai baht in 1997.

Perhaps the strongest argument made by dollar bulls is that foreigners have no alternative to investing in the United States. America, as numerous Wall Street practitioners have told me over the past few months, is the place to be now that an economic recovery is underway. "Where else are they going to go?" one seasoned Wall Street banker asked me scornfully last month. "Europe?"

Actually, yes. Whatever one thinks about the European Union as a political entity, the currency it has spawned has what it takes to rival the dollar as an international reserve currency. One reason the dollar has retained its status as the world's favorite currency is the sheer scale of U.S. trade. Moreover, the prices of most commodities--from oil to gold--are habitually quoted in dollars. But, in terms of GDP, the Eurozone is now the world's second-largest economy, accounting for over 20 percent of global output in 2002, compared with 32 percent for the United States and 12 percent for Japan, the world's third-largest. And the list of countries eager to join the Eurozone is long; nearly all ten new members of the European Union wish to do so. Moreover, in these anti-American times, the idea of pricing oil in the European currency has an obvious appeal to producers like Venezuela, which has a hostile relationship with the Bush administration. Former Malaysian premier Mohammed Mahathir, a vehement critic of the United States, explicitly proposed the idea last year.

In fact, we're already seeing concrete evidence that the euro could supplant the dollar as the international currency of choice. Before the euro's creation in 1999, around 30 percent of total international bond issuance was in its predecessor currencies, compared with more than 50 percent for the dollar. In the past five years, the euro has accounted for 47 percent to the dollar's 44 percent. Perhaps all that is missing is a more expansive monetary policy by the European Central Bank (ECB)--something a growing chorus of European economists are calling for--that would make the Eurozone a more attractive market for foreign exporters. (On the other hand, it may be that the ECB's hawkish anti-inflation stance--and the Eurozone's current account surpluses--are part of the euro's appeal as a reserve currency.)

Is this just the old European fantasy of cutting America down to size? Not in the

eyes of practitioners in the City of London, the world's biggest market for international transactions, who tend to be unbiased observers since the British have declined to adopt the euro. A few weeks ago, at a dinner held in London by one of the biggest U.S. banks for around 18 clients at other major City institutions, I posed the question: Who thought the euro could plausibly replace the dollar as the principal international reserve currency? No fewer than six said they believed it could--and were prepared to admit it before their American hosts.

One hundred years ago, the pound was the world's number-one currency. Yet, Britain's soaring indebtedness during and after World War I allowed the dollar to stake a claim first to equality and then to superiority. It's not exactly clear when the dollar usurped the pound (some say 1915, some say 1931). But, once it did, the turnaround was rapid.

Should that happen to the dollar today, the U.S. economy could face dire consequences. The inflation of the '70s, precipitated by (among other things) the depreciation of the U.S. dollar after the breakdown of Bretton Woods, led to the most stagnant period in postwar U.S. economic history. But the fact that the dollar remained the world's preferred reserve currency limited how far it could fall, and how high interest rates could subsequently rise and squeeze the U.S. economy. The recent emergence of the euro points to a different--and more painful--denouement when this dollar standard breaks up. Charles de Gaulle may yet have the last laugh.

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